VZCZCXRO0773
RR RUEHAG RUEHAST RUEHDA RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA RUEHLN
RUEHLZ RUEHPOD RUEHROV RUEHSR RUEHVK RUEHYG
DE RUEHRA #0202/01 1081406
ZNR UUUUU ZZH
R 171406Z APR 08
FM AMEMBASSY RIGA
TO RUEHC/SECSTATE WASHDC 4853
INFO RUEATRS/DEPTTREAS WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHZL/EUROPEAN POLITICAL COLLECTIVE

UNCLAS SECTION 01 OF 02 RIGA 000202

SIPDIS

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD LG
SUBJECT: UPDATED LATVIAN ECONOMIC OUTLOOK

Ref: Riga 138

¶1. Summary. The consensus among sources continues to be that Latvia's economy will slow throughout the year, though estimates range from the Association of Latvian Commercial Banks' soft-landing scenario of 6.7% GDP growth, to the IMF's hard-landing estimate of 3.1%. However, the inflation that had previously been forecast to peak in mid-summer, is now projected by some experts to not reach its high point until near the end of 2008. Central Statistics Office figures showed that annualized inflation reached 16.8% in March, but both government and private economists believe that rates of 10-11% are possible by December. Producer price and wage inflation has hurt Latvia's competitiveness, but the Latvian Investment and Development Agency claims that foreign investment into Latvia has remained unaffected up to now. While none of the news on the Latvian economy is particularly good, a key question is whether the slowdown will be gentle enough to prevent a spillover into politics. End summary.

Tap, Don't Stomp, on the Brake

¶2. Economists and officials consulted by post (which included representatives of the Bank of Latvia, Finance Ministry, Financial and Capital Markets Commission, Confederation of Latvian Employers, Association of Latvian Free Labor Unions, HansaBanka, Latvian Commercial Banks Association, and the Latvian Investment and Development Agency) agree that the overheated Latvian economy will continue to cool throughout 2008, due to falling aggregate demand and household consumption. In light of consistently growing inflation and Latvia's large current account deficit, a certain degree of economic slowing is much welcomed and anticipated in Latvia. The GOL and Latvian economists, however, have expressed concerns over excessive cooling of the economy. They point to the fact that Latvia's economic development has mostly been consumption-driven and worry that a drastic drop in consumption may result in significantly slower growth or even a recession. The recession scenario is considered unlikely; nevertheless, the government and the Bank of Latvia recently agreed that the government will not enact any further anti-inflation measures and will even rescind a provision enacted last year mandating 10% down payments for large consumer loans. Currently, the PM's office projects 2008 GDP growth will be 6%, OECD forecasts 6.1%, the Economics Ministry says 5.5%, and the IMF foresees a gloomy 3.6%.

When Will the Wave Crest?

¶3. The inflation rate will likely continue to climb, with one HansaBanka analyst saying that a peak annualized monthly rate of 20% is not out of the question. Inflationary pressures will increasingly be cost-pushed rather than demand-pulled. At the start of 2008, the GOL stated that inflation would peak in the summer, with prices then moderating and coming under control near the end of

the year. However, in recent weeks, the Bank of Latvia and private economists have been pushing back projections of when inflation may peak, with some estimates projecting increasing inflation rates until December. Energy and food prices will continue to account for most of Latvia's high inflation. Electricity tariffs increased on April 1 by an average of 37.6%, and natural gas tariffs are expected to increase by 30-50% this summer. Soaring production costs for local producers, coupled with rising global food demand and wheat and milk shortages, will keep pushing food prices upward. Demand for luxury goods and services has already slowed and is expected to fall further.

¶4. In an effort to fight inflation, the government pledged to exercise fiscal restraint and maintain a budget surplus equal to 1% of GDP. However, concerns exist that the GOL might inject some of the surplus funds back into the market if the economy begins slowing too sharply. On April 9, Bank of Latvia Governor Ilmars Rimsevics met with the Prime Minister, and told reporters afterwards that he believes it is essential to maintain the surplus at 1% of GDP, and that the current shortfalls in government revenues (about 1 percent less than expected) should be matched by spending cuts. If the government chooses to boost the economy with funds from the surplus, at a time when substantial EU funds are coming into Latvia, the stimulus could spur continued rapid price growth into 2009.

¶5. Inflation and increasing labor costs are having a negative effect on the competitiveness of Latvian businesses. Latest foreign trade data shows that export growth is slowing, and this trend is likely to continue throughout 2008. Businesses are increasingly calling for government action to enact policies such as export credit guarantees and tax breaks for re-invested profit. The economy is also expected to begin undergoing various structural changes as numerous sectors and industries become less profitable. Import growth is also showing a tendency to slow, which should bring down Latvian's current account deficit. Figures for the 4th quarter of

2007 already indicate that the current account deficit decreased to 17.7% of GDP, down from 27.1% of GDP in the 4th quarter of 2006.

Consumer Lending Slows

¶6. Credit growth this year is still expected to decline, as observed in the second half of 2007, but the banking sector should remain stable. The Financial and Capital Market Commission notes that this decline in lending growth indicates a normalization of the market after a period of extremely high and unsustainable growth. Projections are that mortgage lending will be slowing more than commercial lending; the latter possibly even experiencing some growth. Currently, approximately 80% of loans are issued in euros, rather than in local currency, and the share of Euro denominated loans is expected to grow. The large volume of Euro-denominated debt had been the subject of public and press concern in the wake of rumors last year that Latvia may devalue its currency, the Lat. However, the Bank of Latvia says it continues to hold enough foreign currency reserves to cover every Lat in circulation, and government and banking officials almost unanimously discount the likelihood that Latvia would alter the Lat' peg to the Euro.

--- ------
Wages Go Up, Productivity...Not So Much
--- ------

¶7. Wage growth is forecast to slow whereas unemployment is expected to increase. The most often cited wage growth figures projected for 2008 are between 16 to 17%. This rapid wage growth, without corresponding improvements in productivity, is one of the principal reasons for the decline in Latvia's business competitiveness. Wage growth, nevertheless, is forecast to remain relatively high due to continued labor shortages and the fact that wage levels remain low relative to other EU countries and workers are leaving Latvia to take higher paying jobs elsewhere in the Union. It is thought that unemployment will grow in response to economic slowdowns in sectors such as construction and real estate. Rural regions are

experiencing the highest levels of unemployment and most business activity is concentrated around urban areas. The GOL will continue to work on a territorial reform plan this year, which aims in part to address the economic disparities between urban and rural regions.

Optimism on Foreign Investment

¶8. In discussions with post, the Latvian Investment and Development Agency (LIAA) asserted that the high levels of inflation have not had a negative effect on foreign investment growth - pointing to data that shows that despite high inflation in 2006 and 2007, foreign investment in Latvia continued to grow. LIAA adds, however, that investment growth could slow this year in response to several other factors - among them, downgraded credit ratings and increased production costs. Lower labor costs relative to Scandinavian countries still provide a continued advantage for investing in Latvia. It is projected, though, that the number of investment projects which rely on cheap labor will decrease, and that more attention and resources will be directed toward the promotion of technology intensive, rather than labor intensive, projects.

¶9. Comment: Inflation is likely to peak this calendar year, though later in the year than originally thought. Predicting the peak has been difficult due to continued external factors, such as energy and food costs, but also in the difficulty of identifying the inflationary pressures that are already in the pipeline from 2007. As many in the ruling coalition have a preference for continued high GDP growth and wage convergence with the EU, the political temptation to use the planned government budget surplus to make up for lower revenues may be too strong for the government to resist. If the surplus drops below 1%, Latvia may not only suffer increased inflation from the extra stimulus, but it may also lose the confidence of the major credit rating agencies that Latvia is serious about fighting inflation, and further downgrading of Latvia's credit rating may follow. While not fatal to Latvia's economy, rating agency concerns could make foreign investors bypass opportunities in Latvia, and decrease its long-term growth prospects. Hopes of entering the Euro zone also depend on reigning in inflation and delays in Euro usage also could reduce foreign investment into Latvia.

¶10. Comment, contd. The other key question is whether the economic downturn is gentle enough not to spill over into politics. As noted in reftel, a sharp drop in the economy could have negative consequences for the stability of the current coalition government.